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IN THE

# Supreme Court of the United States

OCTOBER TERM, 1954

No. 286

FANNIE HIRSHON TRUST, U/A CHARLES HIRSHON, WALTER HIRSHON, and HENRY SIEGBERT, TRUSTEES, *Petitioner,*

*against*

COMMISSIONER OF INTERNAL REVENUE, *Respondent.*

## REPLY BRIEF FOR PETITIONER

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COMMISSIONER OF INTERNAL REVENUE, *Respondent.*

## REPLY BRIEF FOR PETITIONER

In our petition for certiorari we have stated that the decision below creates a conflict of appellate views and presents an important question which vitally affects many critical areas of tax administration. We respectfully submit that the respondent's brief in opposition scarcely obviates the need for this Court's expeditious intervention. Indeed, the respondent's arguments plainly reveal how hard he must labor in order to sustain the decision below.

### The Court of Appeals Has Erroneously Decided an Important Question of Law

1. At the very outset the respondent confidently observes that the result below is "clearly correct". (Pet. 8.) In this respect he seems far more certain than the Second and Third Circuits, which have approved the result. For example, unlike the respondent, the Third Circuit has stated

that "almost all the Tax Court cases have gone the other way"[1] and that "the solution is not free from difficulty." *Commissioner* v. *Godley's Estate,* 213 F. 2d 529, 532, 534 (3d Cir. 1954). Nor is the respondent's confidence understandable for another reason. Although he insists that the petitioner's view is "without basis" (Resp. 10), he has taken the very same view in *Equitable Securities Corp.* v. *United States,* 5 C.C.H. 1954 Fed. Tax Rep. ¶ 9530. Evidently the respondent easily moves from one position to another, depending on which one helps him collect a larger tax. Aside, perhaps, from a conflict among courts of appeals, there is no better occasion for certiorari in tax cases than "the resultant confusion" in administration due to "inconsistent positions" by the respondent. Cf. *Estate of Sanford* v. *Commissioner,* 308 U. S. 39, 42 (1938). We are not unmindful of the respondent's promise to be consistent if the Court denies certiorari here. (Resp. 15, n. 7.) But, needless to say, the respondent's assurance is not too comforting. As this Court has so often declared, a denial of certiorari is quite different from an authoritative adjudication by this Court. Hence if certiorari is denied, the same differences of opinion will remain to plague the Tax Court and the courts of appeals. And as long as the uncertainties continue, the respondent will be compelled to be inconsistent "for the purpose of protecting the revenue."

2. Section 115(a) carefully defines a dividend as a distribution made by a corporation out of its earnings and profits. The obvious policy of Section 115(a) is to tax corporate distributions as dividends to the extent that they constitute corporate earnings. See generally *Estate of Putnam* v. *Commissioner,* 324 U. S. 393, 399 (1945); *Commissioner* v. *Munter,* 331 U. S. 210, 214 (1947); *Commissioner* v. *Phipps,* 336 U. S. 410, 419 (1949). As the respondent's own regulations indicate, a distribution qualifies *in*

[1] For some reason which we cannot fully grasp the respondent concludes that the decision below is "but the natural outgrowth of earlier decisions of the Tax Court." (Resp. 16.)

*toto* as a dividend only if the earnings and profits "are equal to or in excess of the total amount" of the distribution. U. S. Treas. Reg. 111, § 29.115(a)-1. See also Sen. Rep. No. 2156, 74th Cong., 2d Sess. 18 (1936). In other words, a taxable dividend cannot exceed the corporation's earnings and profits. The dividend may be less than earnings and profits, but it cannot be more. In this case the Court of Appeals has reached the bizarre conclusion that a distribution is entirely taxable as a dividend though it far exceeds the earnings and profits.

In order to sustain this strange result the respondent invokes an alleged principle of accounting that a distribution in kind reduces a corporation's earnings and profits account by the cost or adjusted basis of the asset to the corporation. We are at a loss to understand the relevance of this argument, whether or not it is otherwise impeccable.[2] The obligations of a taxpayer stem from the words used by Congress and not from some concept enunciated in an accountant's handbook. Taxation is a statutory subject, and any tax "asserted by the Commissioner" must be "authorized by Congress." *Helvering* v. *Griffiths*, 318 U.S. 371, 394 (1943). This Court has particularly emphasized, in regard to corporate distributions, that the tax statutes significantly diverge from technical notions of accounting. See *Commissioner* v. *Wheeler*, 324 U.S. 542, 546 (1945); *Bazley* v. *Commissioner*, 331 U.S.

[2] According to the respondent, no appellate court has held that on a corporate distribution of appreciated property the earnings and profits should be charged with the fair market value of the property rather than its cost basis. (Resp. 15.) The respondent has erred. See *General Securities Co.* v. *Commissioner*, 123 F. 2d 192 (10th Cir. 1941), where earnings and profits were charged with the fair market value of distributed stock, though the court agreed that perhaps "good accounting practices required the stock to be carried on the books of the taxpayer at cost." *Id.* at 194. Cf. *Binzel* v. *Commissioner*, 75 F. 2d 989 (2d Cir. 1935), *cert. denied*, 296 U.S. 579 (1935). In so far as we know, the only appellate decisions which, for dividend purposes, charge earnings and profits with the cost of the distributed asset are the decision below and the Third Circuit's decision in *Commissioner* v. *Godley's Estate*, *supra*.

737, 740 (1947); *Commissioner* v. *Phipps, supra,* at 420. Cf. *Edwards* v. *Douglas,* 269 U.S. 204, 214 (1925). At best a concept of "correct corporate accounting opens questions as to the proper application of a taxing statute; it does not close them." *Bazley* v. *Commissioner, supra,* at 741. And so, as the Government successfully argued in the cases just cited, little is gained by referring to a canon of accounting which may be extremely pertinent in some other context. Cf. *Helvering* v. *Hallock,* 309 U.S. 106, 118 (1940); *Helvering* v. *Clifford,* 309 U.S. 331, 334 (1940); *Lilly* v. *Commissioner,* 343 U.S. 90, 97 (1952).

3. Since the respondent has spent so much time and effort on a canon of accounting, it is hardly surprising that he has overlooked the relevant statutes. For the purposes of this case he seems to be under the impression that the law of taxation is "a matter of pure reason." Cf. *Choate* v. *Commissioner,* 129 F. 2d 684, 686 (2d Cir. 1942). The respondent has tacitly assumed, in disregard of the statutes, that a corporate distribution must derive either from earnings and profits or from book capital. He then supposes that if a distribution does not impair book capital, it must necessarily constitute earnings and profits. The respondent, of course, is obviously ignoring a third source of corporate distributions—unrealized appreciation of assets—though even he distinguishes unrealized appreciation from earnings and profits. (Resp. 9, n. 2, 11.) See *General Utilities Co.* v. *Helvering,* 296 U.S. 200 (1935). Moreover, he seems wholly unaware that for many years Congress has provided an explicit rule for distributions out of unrealized appreciation. We are referring to Section 115(d), which is completely at odds with the respondent's view that when appreciated property is distributed, the corporation's earnings and profits "should be charged with the cost basis, rather than the fair market value, of the property." (Resp. 15.)

Here we have another example where a page of legislative history is much more illuminating than a volume of legal logic. In 1918 the Ways and Means Committee spe-

cifically considered the status of distributions representing unrealized appreciation of assets. At that time the statute did not provide, as Section 115(b) provides, that a corporate distribution is deemed "made out of earnings or profits to the extent thereof, and from the most recently accumulated earnings or profits." Although a corporation had ample earnings, its stockholders could nevertheless escape tax by attributing the distribution to some other source, such as unrealized appreciation. Congress forestalled this kind of avoidance by creating a conclusive presumption that a distribution is deemed made from earnings or profits to the extent that they are available. Revenue Act of 1918, § 201(b). In proposing this legislation the Ways and Means Committee expressly noted that a distribution out of unrealized appreciation is not a dividend for tax purposes. To quote the Committee, "Under court decisions an addition to surplus through reappraisement of assets is not made out of earnings or profits, and therefore a distribution of the amount so added to surplus would not be a taxable dividend, since not made out of earnings or profits." H.R. Rep. No. 767, 65th Cong., 2d Sess. 4 (1918). The Committee then indicated that this rule continued to apply once the distribution exceeded the corporation's earnings and profits.

In 1924 Congress again turned its attention to the tax treatment of distributions out of unrealized appreciation and other sources apart from earnings and profits. The result was Section 201(d) of the 1924 Act, which later became Section 115(d) of the 1939 Code. Section 115(d) provides that if a distribution is not a dividend as defined in Section 115(a), and is not made "out of increase in value of property accrued before March 1, 1913," then the amount of the distribution is to be applied against the basis of the stock and any excess is taxable as a capital gain.[3] Under this provision, the Ways and Means Com-

[3] Cf. Int. Rev. Code of 1939, § 115(b), which states that a distribution is tax-exempt if it is made out of an increase in the value of property accrued before March 1, 1913.

mittee explained, "amounts distributed by a corporation which do not constitute distributions of earnings or profits or increase in value of property accrued prior to March 1, 1913," are "a return of capital to the stockholders [sic] and are taxable to him only if, and to the extent that, they exceed the basis of his stock." As an example of a distribution governed by this special provision the Committee expressly mentioned "distributions out of unrealized appreciation in value of property." H.R. Rep. No. 179, 68th Cong., 1st Sess. 12 (1924).

We believe that these two chapters of legislative history speak for themselves. They clearly indicate that if a distribution, as in this case, exceeds the corporation's earnings and profits, and the excess is attributable to unrealized appreciation, the excess is not taxable as a dividend. The crux of the matter is not whether the distribution impairs capital in some accounting sense, but whether the amount of the distribution is larger than available earnings and profits in a tax sense. On its very face Section 115(d) distinguishes between distributions which constitute dividends and distributions which constitute increase in the value of property. For Section 115(d) "contemplates tax-free distributions out of unrealized post-1913 increase in value." Rudick, "Dividends" and "Earnings or Profits" Under the Income Tax Law: Corporate Non-liquidating Distributions, 89 U. of Pa. L. Rev. 865, 902-903 (1941). The Court of Appeals plainly erred in concluding that Section 115(d) is merely designed to cover "those distributions which have left the capital of the corporation impaired." (Pet. 26.) The respondent's argument builds upon the same manifest error. (Resp. 8.)

4. The respondent's reliance on Section 115(j) further shows the weakness of his position. Section 115(j) merely states that if "the whole or any part of a *dividend*" consists of property other than money, the property "shall be included in gross income at its fair market value at the time as of which it becomes income to the shareholder."

(Emphasis supplied.) To invoke Section 115(j) is only to indulge in question begging. The question in this case is whether the term "dividend" comprehends a distribution which exceeds in amount the earnings and profits of the distributing corporation. Section 115(j) cannot answer this question. As its language readily discloses, Section 115(j) does not apply to any portion of a distribution unless that portion first qualifies as a dividend. The respondent's reference to Section 115(j) only puts the cart before the horse.

Section 115(j) was first enacted as part of the 1936 Act, when Congress imposed the short-lived undistributed profits tax. Thus, the Section first appeared twelve years after Congress had unmistakably indicated that a distribution representing unrealized appreciation, as distinguished from earnings and profits, is not a dividend for tax purposes. Nothing in Section 115(j) casts the least doubt upon that rule as articulated in Section 115(d). It would indeed be strange if Congress had overruled Section 115(d) by subtle implication.[4] It would be stranger still if Congress intended, by passing Section 115(j), to tax distributions in excess of earnings and profits. At the very time when Section 115(j) was enacted, the Senate Finance Committee declared that "distributions during the year, *not exceeding in amount the current earnings,* are dividends constituting income to the shareholders."[5] It would be equally unusual for Congress to make such a fundamental change in the longstanding policy of Section 115(d) without some explanation. The Committee Reports contain no reference whatever to Section 115(j), which, the respondent apparently believes, amended Section 115(d).

The respondent's view of Section 115(j) necessarily inflicts a double tax upon distributed earnings—a result

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[4] In fact, when Congress wishes to deviate from that rule, it expressly so provides, as it did in the newly enacted Internal Revenue Code of 1954. Int. Rev. Code of 1954, Section 312(b).

[5] Sen. Rep. No. 2156, 74th Cong., 2nd Sess. 18 (1936). (Italics supplied.)

certainly to be avoided unless required by express words.[6] To take a simple example, a corporation has accumulated earnings and profits of $15,000. It distributes an asset worth $20,000 which has a cost basis of $10,000. The respondent would tax the $20,000 as a dividend but charge earnings and profits with $10,000, leaving $5,000 of earnings and profits for future distributions. A distribution of $10,000 in the following year, when the corporation had no current earnings and profits, would be taxed as a dividend to the extent of the $5,000 of undistributed earnings and profits. Thus the shareholders would be taxed upon "dividends" of $25,000 even though the earnings and profits totaled only $15,000.

The decision below not only taxes amounts in excess of earnings and profits, but it also makes the taxable amount depend on the sequence of distributions. Thus, suppose that a corporation with accumulated earnings and profits of $5,000 has available for distribution cash of $5,000, and property with a cost of $5,000 and a fair market value of $100,000. If the corporation first distributes the cash and then the property, the decision below leads to the conclusion that only $5,000 is taxable as a dividend. But if the order of distribution is reversed, $100,000 is taxable to the shareholder.

### The Decision Below Is in Conflict With Decisions of Other Courts of Appeals

In our petition for certiorari we have pointed out that the decision below is in conflict with the Sixth Circuit's decision in *Commissioner* v. *Timken*, 141 F. 2d 625 (6th Cir. 1944), and the Fourth Circuit's decision in *Timberlake* v. *Commissioner*, 132 F. 2d 259 (4th Cir. 1942). The latter decision rests on the principles enunciated by this Court in *Palmer* v. *Commissioner*, 302 U.S. 63 (1937). While the respondent contends that there is no conflict

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[6] *United States* v. *Supplee-Biddle Hardware Co.*, 265 U. S. 189, 196 (1924); *Maass* v. *Higgins*, 312 U. S. 443, 449 (1941).

(Resp. 11-14), his argument is not persuasive. For that matter, he seems to misunderstand our analysis.[7] The conflict seems inescapable unless we are to ignore both the reasoning and the result in the court below.

1. In the *Timken* case the Government attempted to reach the same result as in this case and failed. There, as here, the question was whether a distribution of appreciated property was a dividend where the corporation's earnings and profits were insufficient to cover its fair market value. And there, as here, the Government similarly charged the cost of the property to available earnings and profits, and sought to tax the appreciation as a dividend. In the *Timken* case the corporation made two other distributions in the same year consisting of cash. The available earnings and profits were only 88.58 percent of the sum of the two cash distributions plus the cost of the appreciated property. Therefore, the Government charged 88.58 percent of the cost of the property to earnings and profits, and treated 88.58 percent of the appreciation as a dividend.[8] In short, the Government did precisely what it has done in this case—except that in the *Timken* case

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[7] For example, the respondent mysteriously infers that we regard the *Timberlake* case as one in which the unrealized appreciation of the distributed property was not charged to earnings and profits. (Resp. 13-14). We are baffled by the respondent's impression, for our position is precisely the opposite. See p. 10.

[8] The *Timken* case involved earnings and profits for the taxable year, rather than accumulated earnings and profits. However, under Section 115(a) this distinction is, of course, immaterial. Section 115(a)(2) states that the earnings and profits of the taxable year are to be "computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year." In addition, the earnings and profits are to be determined "without regard to the amount of the earnings and profits at the time the distribution was made." In the *Timken* case there were no earnings and profits when the appreciated property was distributed. But, as the Government correctly concluded, the absence of earnings and profits at that precise moment was immaterial, since there were current earnings and profits for the year as a whole.

the earnings and profits did not quite cover the entire cost of the distributed property. Hence it seems rather clear that the decision below and the decision in the *Timken* case are irreconcilable. If the decision below is correct, then, obviously, the Government should have prevailed in the *Timken* case.

2. The decision below is equally in conflict with the *Timberlake* decision. In that case a corporation sold appreciated property to its stockholders for an amount equal to its own cost. The Fourth Circuit held that the unrealized appreciation—the difference between the corporation's cost and the fair market value at the date of sale—constituted a dividend. In reaching this conclusion the court painstakingly noted that the unrealized appreciation was fully covered by earnings and profits. The unrealized appreciation, not the cost, of the property was charged against earned surplus. Since the corporation was paid an amount equal to the cost of the property, there was, indeed, no way of taxing the distribution as a dividend except by charging the appreciation to earnings and profits. Here, however, the Second Circuit has held that it is immaterial whether the earnings and profits are more or less than the value of the distributed asset. As the Second Circuit puts it, "in determining whether the distribution of an asset in kind is a dividend under §115(a) the earnings and profits of the corporation are charged with the *cost* of the asset to be distributed, without regard to any unrealized appreciation in its value."[9] (Pet. 25.) The Second Circuit's view is in direct conflict with the Fourth Circuit's understanding of Section 115(a). As a matter of fact, if the Second Circuit's opinion is correct, the distribution in the *Timberlake* case should not have been taxed as a dividend. For there the earnings and profits were not charged with the cost of the distributed property because the corporation sold the property to the stockholders at cost.[10]

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[9] Italics in original.

[10] See Pet. 15.

Apparently the respondent has had a difficult time in attempting to cope with the *Timberlake* decision. (Resp. 14, n. 5.) He admits that in the *Timberlake* case the cost basis of the distributed property was not charged against earnings and profits. He then observes that neither were the earnings and profits "reduced by the amount of the appreciation in value." Having made this statement, the respondent is still dissatisfied. For in effect the respondent is saying that though a dividend is a distribution of earnings and profits, it need not reduce earnings and profits. Since even the respondent is troubled by this remarkable notion of a dividend, he turns to another rationalization of the *Timberlake* decision. He now declares that the distribution of the appreciation in value increased the corporation's earnings and profits. This explanation is as poor as the other. As the respondent himself recognizes,[11] almost twenty years ago this Court unanimously held that a distribution of appreciated property does not increase a corporation's earnings and profits. *General Utilities Co.* v. *Helvering, supra.* However, it is not surprising that the respondent pays so little attention to the *General Utilities* decision. In the end he rather candidly justifies the opinion below as a way of overcoming this Court's decision in the *General Utilities* case. (Resp. 16-17.) While the respondent's frankness is commendable, we prefer to believe that only this Court, apart from Congress, can overrule a decision rendered by this Court.

**Conclusion**

The respondent does not deny that the decision below will be extremely unsettling. Indeed, he serves notice that the Second Circuit's reasoning should equally apply under the Internal Revenue Code of 1954. (Resp. 14, n. 6.) Nor does the respondent deny that the decision must inevitably have important effects in many other areas of the

[11] Resp. 9. n. 2.

tax law. The concept of earnings and profits and the related concept of a dividend critically affect a large variety of tax questions. We have already given a number of notable examples. (Pet. 8-10.) Other significant examples are distributions in certain corporate liquidations[12] and distributions in connection with corporate reorganizations.[13] It requires little imagination to foresee the confusion which will attend the decision below. The respondent's brief sufficiently reveals the shape of things to come in the administration of the tax law unless the decision below is reversed. Despite the provisions which meticulously define a dividend as a distribution *out of* earnings and profits the respondent boldly denies that "a reduction in earnings and profits is always a prerequisite to a dividend." (Pet. 13.) This statement is by no means surprising, for the respondent has already attempted to tax as a dividend a distribution by a corporation which had *no* earnings or profits.[14] It seems quite clear, we believe, that certiorari is most appropriate here.

Respectfully submitted,

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[12] Int. Rev. Code of 1939, § 112(b)(7); Int. Rev. Code of 1954, § 333.

[13] Int. Rev. Code of 1939, § 112(c)(2); Int. Rev. Code of 1954, § 356(a)(2).

[14] See respondent's brief in Michael Erburu, T.C. Docket No. 51137, in which he contends that a distribution of appreciated property is a dividend though the corporation has no earnings and profits whatsoever.